

Your Audit Defense Toolbox

Section 2

Your Audit Defense Techniques

This section of the Toolbox provides a general discussion of the most common techniques used by tax professionals to limit sales/use tax liability for their clients. Please keep in mind that this information is for reference purposes only. Users of this information do so at their own risk. www.SalesTaxReference.com and/or its owners are not responsible for any consequences from the use of the information contained in this document.

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Initial Contact: Limiting the Scope of the Audit

The initial contact(s) with the auditor may give you an opportunity to decrease the size and/or complexity of the audit. More specifically, you may be able to prove to the auditor that certain parts of your business are not relevant to the audit and do not need to be examined. In order to do so, you need to have a solid understanding of your business activities in relation to sales/use tax law.

One of the most important terms to understand is 'nexus'. For purposes of sales/use tax, nexus is generally described as a physical connection between your business and a taxing jurisdiction. At the most basic level, if you have nexus, then you are subject to that jurisdiction's sales tax. You may have nexus if your business meets any of the following criteria:

1. You have a physical location, such as an office, in the taxing jurisdiction.
2. You have property located in the taxing jurisdiction. Renting, leasing, or storing property in the state may fall into this category.
3. You have employees or agents in the taxing jurisdiction. This includes salespeople that travel into the jurisdiction, telecommuters that work from home in the jurisdiction, agents that represent your business in the jurisdiction, or employees that attend tradeshow/conventions in the jurisdiction.
4. You have delivery vehicles that travel into the jurisdiction to deliver goods/services to customers.

States can be very aggressive in trying to establish nexus with a business, since this is how they can increase tax revenues. If you can demonstrate to an auditor that your business does not have nexus with the jurisdiction, you may be able to avoid being audited at all. If this is the case, you should present this position as early as possible in the audit process. You will need to provide evidence to the auditor proving you do not have any physical locations, property, or employees located in the jurisdiction. You may also have to answer other questions the auditor may have regarding your business

activities. While avoiding an audit in this way is uncommon, it can happen, as jurisdictions may go on 'fishing expeditions' and send out audit notice letters to businesses that do not necessarily have nexus with the state. Remember - just because you receive an audit notice, it does not give the state free reign to audit your business. If you can prove that you don't have nexus with the state, then you can send that auditor on to the next taxpayer!

If you can't completely avoid an audit by demonstrating a lack of nexus, you may be able to limit its scope to certain areas of your business. For example, if you are an out-of-state business that only has nexus with the state due to salespeople entering the state, you may be able to limit the audit to an examination of your sales into the state. To do this, explain to the auditor that you do not have any locations or property in the jurisdiction and thus, you should not have to go through an audit of your fixed asset and expense purchases. By doing so, you may be able to decrease the documentation requested by the auditor and cut the scope of the audit in half. However, keep in mind that they may request information on expense purchases related to items used by the salespeople while in the state and/or promotional items that are given away by the salespeople to customers in the state.

Finally, you may be able to limit the time period that the auditor examines. Most states have a three or four year statute of limitations. In general, the statute of limitations defines the time that a state can go back to examine your records and assess tax against your business. However, if you have never filed a tax return, and you should have, most states can go as far back in time as they want to assess tax! So if you receive an audit notice letter for an audit of the last four years and you can prove that you only started doing business in that jurisdiction two years ago, you may be able to cut the audit in half. To do so, you must demonstrate that you did not have nexus with the jurisdiction before two years ago, and/or you did not have any sales in the jurisdiction before two years ago.

These are some basic ideas that you may be able to use in order to limit the scope of your audit before any field work gets underway. Remember to keep these issues in mind

when starting a new audit, as you can be sure that the auditor will do their best to widen the audit in order to examine as many areas of your business as possible!

Next, this section of the Toolbox will look at the most common audit sampling techniques and how they can be utilized by a taxpayer.

A General Overview of Common Audit Sampling Methods

As discussed in the first section of the Toolbox, most audits are conducted using sampling techniques to examine the sales and expense portions of the audit. By doing so, auditors minimize the amount of documentation they need to review. This portion of section two provides a basic overview of the most common sampling techniques that you may encounter during an audit. Understanding the different techniques will help ensure that the most beneficial method is being applied to your audit. The techniques that we will cover are:

1. 'Old School' Block Sampling - Non-Statistical
2. Percentage of Error Block Sampling – Non-Statistical
3. Ratio Analysis - Statistical Sampling
4. Other Methods

The main difference between the statistical and non-statistical methods is that with statistical sampling methods you can accurately measure the risk that the chosen sample is representative of the entire audit period. When using the non-statistical sampling methods, you can never truly know if it will result in an accurate representation of the entire audit period. Many states are moving toward statistical sampling, especially for larger audits. However, the non-statistical methods are still commonly used today and, in general, are considered reasonably accurate by most sales/use tax professionals.

'Old School' Block Sampling – Non-Statistical

The 'Old School' or traditional block sampling method is quite simple. In this method, the auditor and taxpayer agree on a sample period (usually one to three months), the auditor

examines the documentation for the sample, and any tax due is multiplied by the proportionate time period under audit. Let's look at an example:

ABC Company is being audited for sales tax. The audit period is four years (48 months). The taxpayer and the auditor agree to use traditional block sampling to review sales. Two months is the agreed upon sample period. The auditor reviews all the non-taxed sales transactions and related documentation for the two sample months and identifies \$10,000.00 in sales that should have been taxed. Using a 5% sales tax rate, the tax due for the sample period is \$500.00 ($\$10,000.00 \times .05$). To project the tax due for the total audit period, the auditor divides the total audit period by the sample period:

1. $48 \text{ months} / 2 \text{ months} = 24$

The auditor then multiplies the tax due in the sample by the results in step one.

2. $\$500.00 \times 24 = \$12,000.00$

The total tax due for the audit is \$12,000.00

As you can see, this method is very simple to use; however, it is not always effective for accurately projecting the total audit liability. One reason for this is that it does not take into account any types of fluctuations in the business, such as an increase/decrease in sales due to seasonal changes. For instance, in the above example, if the two months in the sample period were both months where sales are unusually high, the projected tax of \$12,000.00 is most likely higher than the true tax due because the sample results are blindly projected across the entire audit period.

The next non-statistical sampling method, Percentage of Error block sampling, is used more frequently in today's audits than Traditional block sampling. This is due to the relative inflexibility described above. However, if you have to use the Traditional method in your audit, try to use it to your advantage by negotiating sample periods that you know are "clean" compared to the other periods in the audit period. At a minimum, try to stay away from months that you are sure have significant tax exposure. By doing so, you may be able to minimize any tax liability on these portions of your audit.

Percentage of Error Block Sampling – Non-Statistical

The Percentage of Error block sampling method may be the most common non-statistical sampling method used in today's audits. It is similar to traditional block sampling in that the auditor and taxpayer agree on a sample period, the auditor examines the documentation for the sample and identifies any tax due. However, unlike the traditional method, Percentage of Error block sampling uses an error percentage applied to total exempt sales for the audit period in order to try to create a more accurate tax liability projection. Let's look at an example:

ABC Company is being audited for sales tax. The audit period is four years (48 months). The taxpayer and the auditor agree to use Percentage of Error block sampling to review sales. Two months is the agreed upon sample period. For the two month sample period, total exempt sales (sales where no sales tax was charged) was \$100,000.00. For the entire 48 month audit period, total exempt sales was \$6,000,000.00. The auditor reviews all the exempt sales transactions for the two sample months and identifies \$10,000.00 in sales that should have been taxed. To project the tax due for the total audit period, the auditor first divides the sample period sales that should have been taxed by the total exempt sales for the sample period:

1. $\$10,000.00/\$100,000.00 = 10\%$

The 10% calculated above is the audit 'Error Percentage'. This percentage is then used to project the total taxable sales of the audit by multiplying it by the total exempt sales of the entire audit period.

2. $10\% * \$6,000,000.00 = \$600,000.00$

Now the \$600,000.00 is the projected total taxable sales for the entire audit period. To get the total tax we multiply \$600,000.00 by the 5% tax rate:

3. $.05 * 600,000.00 = \$30,000.00$ tax due

Once again, this method does not take into account the fact that “clean” or “dirty” sample months could be chosen to skew the projection. In most cases, auditors try to limit this issue by requesting three or four sample months (often one from each year in the audit period) in order to increase the odds of a more representative sample. From the taxpayer’s perspective, it is very important to make sure that the sample months chosen are fairly representative of the activity during the full audit period (or “cleaner” and thus more favorable to the taxpayer!). The main benefit of the Percentage of Error method is that the use of an error percentage applied to total exempt sales reduces some of the risk of an inaccurate tax liability projection when compared to the blind projection method of traditional block sampling.

Statistical Sampling

The third sampling method that we will discuss is statistical sampling, or more specifically: the Stratified Dollar Value Ratio Analysis method. This method is more complicated than the aforementioned techniques. However, it usually provides a greater degree of accuracy when projecting any tax liability, as using the various statistical sampling techniques allows a taxpayer to quantify the risk that the sample is not representative of the entire audit period. This method is increasing in use in many state audits, especially where the volume of transactions is very large, as it allows an auditor to review a much smaller level of documentation while maintaining a certain degree of accuracy.

In this method, the taxpayer provides the auditor with a computer file containing detail on every sales and/or expense transaction which occurred during the audit period. The auditor or an audit computer specialist then uses sampling software to sort all of the transactions into dollar value categories. For example, all transactions between \$100.01 and \$500.00 may go into one ‘strata’, all transactions between \$500.01 and \$2,500.00 may go into a second strata, all transactions between \$2,500.01 and \$20,000.00 may go into a third strata, and all transactions \$20,000.01 and up may go into a fourth strata. (As a side note, many sales/use tax professionals request that the auditor throw out all transactions under \$100.00 in order to concentrate the audit on ‘material’ transactions. Depending on the nature of your business, this may or may not be feasible).

The auditor will then use the sampling software to determine a sample of transactions from each stratum with the fourth strata being examined in detail (“in detail” means that every transaction in this group would be examined by the auditor). The number of transactions chosen for each stratum will be determined using the chosen statistical sampling method in order to achieve an agreed upon reliability level that the sample accurately represents the entire audit period (be sure to ask the auditor how the software is calculating the sample size!). Then, similar to the Error Percentage method, the auditor will examine the documentation for each stratum sample, locate any taxable exceptions, and calculate an error percentage. Using the ratio analysis statistical sampling method, the error percentage for each stratum would then be multiplied by the total exempt sales for each stratum to come up with a total taxable amount for each stratum. The applicable tax rate would then be applied to each stratum to come up with the tax due. Let’s look at an example:

ABC Company is being audited for sales tax. The audit period is four years (48 months). The taxpayer and the auditor agree to use Stratified Dollar Value statistical sampling to review sales. ABC provides the auditor with a computer disk containing data for all of the sales during the audit period. The auditor breaks down the data into strata using their sampling software. The strata are as follows:

Strata	Population \$\$ Range	Total Population	Population Count	% of Population	Sample Size
1	\$100.01- 500.00	\$5,000,000.00	25,000	8%	200
2	\$500.01- 2,500.00	\$10,000,000.00	12,000	15%	200
3	\$2,500.01- 20,000.00	\$20,000,000.00	5,000	31%	200
4	\$20,000.01 and up	\$30,000,000.00	250	46%	250
		\$65,000,000.00	42,250	100%	850

As shown above, each of the first three strata has a total of 200 sample items for which the auditor must review the applicable documentation. Note that the fourth stratum, which is reviewed in detail, has only 250 items but makes up nearly half of the total dollar population.

Next, similar to the non-statistical methods, the auditor would examine the documentation for all of the sample items and come up with a schedule of taxable exceptions (sample errors) for the taxpayer. Once the auditor and taxpayer agree on the exceptions, the auditor would project the tax due using the ratio analysis method. Using our example data, the projection might look like this:

Strata	Total Population	Sample Dollars	Sample Errors	Error Rate	Taxable Pop.	Tax
1	\$5,000,000.00	\$50,000.00	\$2,000.00	0.04	\$200,000.00	\$13,000.00
2	\$10,000,000.00	\$200,000.00	\$7,000.00	0.04	\$350,000.00	\$22,750.00
3	\$20,000,000.00	\$1,000,000.00	\$25,000.00	0.03	\$500,000.00	\$32,500.00
4	\$30,000,000.00	\$30,000,000.00	\$500,000.00	-	\$500,000.00	\$32,500.00
	\$65,000,000.00	\$31,250,000.00	\$534,000.00		\$1,550,000.00	\$100,750.00

As an example of how each stratum calculation works, Stratum 1 is calculated as follows:

The auditor examines the documentation for the 200 items in the stratum and finds \$2,000.00 in taxable errors. In order to calculate the error rate \$2,000.00 is divided by \$50,000.00 (the total sample population) in order to get the 4% error rate. This error rate is then multiplied by the total population for the stratum to get the taxable population ($.04 * \$5,000,000.00 = \$200,000.00$). The taxable population is then multiplied by the 5% tax rate to come up with the tax due ($\$200,000.00 * .05 = \$13,000.00$).

As you can see, the tax due is projected separately for each stratum. In addition to the ratio analysis, there are numerous other statistical sampling methods. Be sure that you clearly understand the method(s) used by your auditor before agreeing to move forward.

Other Sampling Methods

While the aforementioned methods are the most commonly used in today's audits, you may come across many additional sampling methods. This may be due to numerous reasons, such as the specific nature of your business, the complexity of various issues under audit, the quantity (or lack thereof) of documentation available, or numerous other reasons. From an audit defense perspective, it is very important that you understand the method that the auditor wishes to employ and how that method will affect your audit. Remember that the sampling method chosen by the auditor is not set in stone! If you feel that the chosen method is not representative of the whole audit period, speak up! If you can make a case for why a method is not viable and why an alternate method would be more accurate, the auditor should be willing to consider it. If your concerns are legitimate, and the auditor is not willing to work with you, this may be an issue to discuss with the audit supervisor before moving forward.

After the sample has been chosen, it is time to collect all of the applicable documentation. As outlined in section one, most sales/use tax professionals prefer to pull all the documentation before the auditor arrives. This is in order to limit the auditor's access to unrelated information. Another reason for pulling the information ahead of time is that it gives the taxpayer a chance to identify any possible issues and build a plan to defend them! While section one of the Toolbox provides more detail on what goes into pulling documentation, we will address two additional tips here:

1. The State auditor may ask for the world, but only give them the state!
 - a. This means that most auditors will ask for a great deal of information that is often unrelated or unnecessary for completion of the audit. Remember that an auditor is not 'all powerful' and thus, you do not have to provide information that is not pertinent to their specific state audit. For example,

they may ask for Federal income tax returns or information pertaining to business conducted in other states. Requests such as these are usually not applicable and should not be provided.

- i. As discussed in section one, always remember the Cardinal Rule of audits: Only provide the auditor with enough information to effectively complete the audit. Nothing more and nothing less!
 - ii. Keep in mind that auditor requests that are practical and related to the audit should be fulfilled. Purposely trying to delay an audit or withhold information will usually result in an upset auditor and a jeopardy assessment for your business.
 1. A jeopardy assessment is when an auditor immediately closes the audit and assesses tax based on the information currently available. This assessment is almost always significantly higher than if a complete audit was performed.
2. Digging up old information can be difficult!
- a. Taxpayers often have difficulty locating documentation for audits for periods far in the past. Records may have been prematurely destroyed or lost, or employees that were present at the time the records were compiled may have moved on. Whatever the reason, it is important to exhaust all possibilities in order to locate the records, as adequate documentation is one key to an effective audit defense! A few tips in this area are as follows:
 - i. If there is a large volume of transactions in a sample that are from the same vendor, you may be able to prove all of them by giving the auditor a 'sample of a sample.' For example:
 1. You are processing the expense purchases portion of an audit. There are twenty invoices from the same vendor in the sample. The auditor agrees that all twenty invoices will be removed from the audit if you can provide 5 of the

invoices and they all prove to be nontaxable and/or tax was correctly charged on the invoice,

- a. This is a powerful tool for reducing the amount of documentation you need to pull and for 'problem' vendors where you may not have 100% of the related invoices.
- ii. If you are having trouble locating invoices or contracts for purchases made by your company, try calling the vendors directly. Most vendors are happy to help customers by providing another copy of a prior invoice/contract!

At this point, the sample has been chosen, all the necessary documentation has been gathered, the auditor has reviewed all of the information, and provided you with schedule(s) listing all of the taxable exceptions. Now it is your job to reduce the audit liability by reducing those taxable schedules as much as possible! In order to do so, most sales/use tax professionals will address each individual taxable exception and ask the following questions:

1. Is the customer exempt?
2. Is the product or service exempt?
3. Did the customer already pay the corresponding use tax?

By asking these questions, a sales/use tax professional is attempting to exhaust all possible means to prove that each item on the auditor's 'taxable' schedule(s) was correctly billed as non-taxable.

A General Overview of Sales Tax Audit Defense Tools

Is the Customer Exempt?

Asking this question is often the easiest way to remove items from the auditor's taxable exception schedule. The most common reasons a customer may be exempt are as follows:

1. The customer is a Federal government entity.
 - a. The Federal Government and its agencies/instrumentalities are exempt from all state and local sales taxes. Thus, if you have a sale to the U.S Army, the Internal Revenue Service, or another Federal entity, it is exempt from sales tax. If this is the case, you still need to prove to the auditor that the sale was made to the Federal government. Usually providing a copy of the invoice(s) to the auditor that shows that the 'bill to' and 'ship to' is a Federal Govt. entity will suffice to prove the exemption, but you may also need to show proof that the item was paid for with Federal Govt. funds and/or ordered on a Federal Government issued purchase order (PO) in order to satisfy a more "thorough" auditor.
 - b. In addition to the traditional PO driven sale, you may come across sales where an individual employee made the purchase on behalf of a Federal government entity using a Federal government procurement credit card (the 'bill to' on the invoice may be listed as an individual). In this instance, you will most likely need to provide proof to the auditor that the credit card used to pay for the purchase was indeed a federal government credit card versus a personal credit card. To do so, you can reference the following document issued by the General Services Administration (GSA) - the Federal government's procurement division. This [document](#) explains the Federal procurement card program and provides information that taxpayers can use to identify a Federal government procurement card. In general, you can identify such a procurement card by the first four digits of the credit card number. Additional state specific information can also be found at the GSA's website [here](#). Finally, for additional input on this situation, many state departments of revenue have regulations, notices, or other formal documents that describe their acceptance of Federal government procurement cards. You can access this information through each 'state' page on [www.SalesTaxReference.com](#).

- c. It is important to note that a government contractor is not the Federal government! You may come across a contractor that is purchasing taxable items for purposes of reselling to the Federal government and they claim a Federal government exemption. In these cases, the customer will need to provide proof that they are an agent of the Federal government (a copy of the Federal contract stating such) and/or that the items were paid for with Federal funds. If they can't do this, they would need to provide a valid resale certificate (sales for resale are discussed below) to obtain an exemption. Be sure to reference the specific state laws to understand their treatment of this situation, as some state may offer exceptions to this rule.

2. Customer is a State/Local Government entity

- a. Most states also exempt any sales to state or local government entities. Thus, similar to sales to the Federal Government, you need to prove to the auditor that the sale was made directly to such an entity. This may require proof of payment by the entity (copy of cancelled check, etc.) a government entity issued PO, or a state issued exemption certificate (for example, Massachusetts requires that the retailer keep a copy of the purchaser's forms ST-2 and ST-5 on file). If you have a practical auditor, he or she may just accept a copy of the invoice that shows that the state/local government entity purchased the item. The level of documentation required to prove such an exemption may vary from state to state and auditor to auditor.
 - i. Also keep in mind that some states do not exempt sales to state and local government entities at all! Thus, these customers have to pay (and you have to charge) the sales tax on their purchases just like every other business! One example of this is the state of California.
 - ii. State and local government entities may also have their own purchasing card program for employees. In general, the same rules apply as with the Federal purchasing card program

discussed above. However, you will need to contact the related state/local entity purchasing/procurement division in order to obtain the necessary card number identification information. You should be able to do so by using the related state agency contact links on www.SalesTaxReference.com.

3. Customer is a non-profit or charitable organization
 - a. Most states also exempt sales to recognized non-profit and/or charitable organizations. In order to correctly exempt such sales, the majority of states require that vendors keep a copy of an exemption certificate from such organizations. Keep in mind that the exemption form(s) and specific requirements will vary from state to state. For example, one organization that qualifies as exempt from sales tax in state A may not qualify in state B!
 - i. Another point to keep in mind is that if a customer provides a copy of their Sec. 501(c)(3) letter from the Internal Revenue Service, in almost all cases, this will not be sufficient documentation to exempt the customer from a state sales tax! This letter only exempts the entity from Federal income tax. In these cases, a polite call to the customer explaining the problem and pointing the customer to the correct exemption form is all that is usually required to correct the issue (many customers simply do not understand what is required for a state sales tax exemption).
 - ii. Similar to state/local government entities, some states do not exempt sales to non-profit or charitable organizations. Thus, these customers have to pay (and you have to charge) the sales tax on their purchases just like every other business. Be sure to confirm this with your applicable state.
4. Direct Pay Customer
 - a. Some businesses decide it is easier to pay all of their sales tax liabilities directly to the state government instead of to the retailers from which they

purchase goods and services. These customers have been issued direct pay permits and thus, are exempt from sales tax in the state where the permit was issued.

- b. A direct pay permit basically says “Dear Retailer, don’t charge me any tax on what I buy from you because I believe that I can better determine what is taxable and thus, I am going to self-assess the tax and pay it directly to the state on my tax return.”
- c. As long as the customer gives you a current direct pay permit, you can confidently exempt the customer. Be sure to keep the permit in your records, as you will need to provide a copy of this permit to the auditor in order to prove that the customer is exempt.

5. Customer is Buying the Item for Resale

- a. In many cases, you may be selling tangible personal property to a customer that plans to resell the item to their customer. This type of transaction is called a sale for resale and is an exempt transaction. The logic behind this concept is as follows: A retail sales tax is a transaction tax. The tax is applied on the retail sale of tangible personal property and select services. When a customer buys an item and plans to resell it to their customer in the regular course of business, their purchase is a wholesale transaction, not a retail transaction, thus a retail sales tax would not apply. When your customer then resells the item to their customer, the end user/consumer of the property, it then becomes a retail sale and they would charge the appropriate sales tax on this transaction.
- b. If your customer is claiming a sale for resale, you will need to request a resale certificate from them in order to correctly exempt the sale. Most certificates are state issued forms from the state where the item is being shipped to. However many states also accept the multi-state resale certificate provided [here](#) by the Multi-state Tax Commission. In addition, states that are members of the Streamlined Sales and Use Tax Agreement will also accept this [form](#).

- i. A very important point is that the resale certificate (and all types of exemption certificates) is completely and correctly filled out, as auditors can and will reject a certificate because it is not complete/correct! If the certificate is rejected, then you, the seller, are liable for the tax unless you can contact the customer to get a new certificate! Most certificates will require the following information:
 - 1. Name of purchaser
 - 2. Address of purchaser
 - 3. Sales tax registration number or invoice number
 - 4. Description of items purchased
 - 5. Description of the purchaser's business
 - 6. Statement that the item is purchased for resale
 - 7. Proper signature and date

- ii. Also remember that each state's resale certificate requirements may differ considerably! For example, Alabama just requires the reseller's Alabama permit number for a valid resale exemption, while Florida only accepts the state issued resale certificate that is reissued to every reseller every year! Be sure to understand your state's requirements!

- iii. You should also be able to recognize the difference between a 'blanket' resale certificate and a 'single use' certificate. A blanket certificate allows the seller to set up the customer's account as completely exempt. The blanket certificate is stating that ALL items purchased by this customer are exempt. In contrast, a single use resale certificate is only valid for the individual purchase for which the customer is claiming the exemption. The single use certificate should identify the specific purchase by noting the invoice, sales order, or purchase order number(s) on the

certificate. Remember that a customer using single use resale certificates must submit a new certificate for every purchase!

- iv. One difficult situation that may also come up in this area is when a customer claiming the resale exemption gives you their 'home state' certificate. In this instance, the customer is claiming a sale for resale exemption, but they are not registered for sales tax in the state where the item is being shipped, thus they can't provide a resale certificate from that state (most likely a 'drop shipment' transaction. This issue will be covered in greater detail in section three of the Toolbox). In these cases, they will give you a copy of their resale certificate from their home state in lieu of the destination state certificate. Only certain states will accept this as proper exemption documentation, so if you receive this from a customer, be sure to confirm with the state in question that this is allowed.

1. In addition, remember that a 'home state' resale certificate is only valid if the purchaser is not registered AND does not have a location in the "ship to" state. If you know that the customer does have a location in the state but is not registered for sales tax, you should not, in good faith, accept the 'home state' certificate for an exemption.

The aforementioned types of exempt customers are the most common, however many states have other types of customers that may be exempt from sales tax. In general, all types of customer exemptions will require that the seller accept a properly completed exemption certificate in order to validate the exemption. This point cannot be stressed enough! Be sure that the certificate is signed, dated, a valid exemption is claimed, and any other requirements are completed before exempting the customer! Finally, keep in mind that it is the customer's responsibility to prove to you, the seller, that they have a valid exemption. If you are not confident that the exemption is legitimate, go back to the customer, politely explain your concerns, and request clarification. Remember that auditors are experts at rejecting incomplete exemption certificates and/or incorrectly

claimed exemptions. If they do so, they will assess tax against your business (you usually have the option of asking the customer for reimbursement. However, this may be difficult to achieve and is often viewed as damaging to the customer relationship.)

Is the Product/Service Exempt?

In general, the sale of tangible personal property will be subject to sales tax in every state unless there is a specific exemption that asserts otherwise. Tangible personal property (TPP) is generally defined as all property, other than land and buildings, which can be felt or touched. Examples include furniture, cars, jewelry, and artwork. Of course, intangible personal property such as shares of stock or a patent would not be considered TPP. Some common state exemptions of TPP may include the following:

1. Manufacturing, Machinery, and Equipment Exemption
 - a. Many states exempt the purchase of TPP that will be directly used to produce other types of TPP that will be sold at retail. Examples of this may include parts or machinery used to produce an automobile, or chemicals that are used to produce medicine. The key to remember here is that the items have to be used directly in producing the new items. If it is used indirectly, it most likely will not qualify. For example, a purchaser usually can't claim this exemption for cleaning supplies that are used to clean the warehouse after the products are manufactured and shipped out. It is also important to remember that each state with such an exemption will have its own specific rules on what qualifies. Also note that this exemption may require the customer to give you a certificate certifying the type of exemption.

2. Enterprise Zone Exemption
 - a. States may have different names for this exemption, but in general an Enterprise Zone exemption is given to a business that agrees to open a plant, office, or other business in a formally recognized distressed area of the community. Essentially, the state is giving the business an incentive

(exemption from sales tax, property tax, etc.) to expand the business in hopes that it will create jobs and improve the area.

- b. When a customer claims this exemption, be sure that it meets the state specific rules on what qualifies for the exemption. Also ensure that the customer provides the properly completed exemption certificate, if applicable!

3. Temporary Storage/Configuration Exemption

- a. This exemption is for property that is purchased and temporarily shipped into a certain state. While in the state, the property is adjusted, configured, or simply held for a short period of time before being shipped out of state to its final destination. The logic behind this exemption is that the sales tax should be based on the property's ultimate destination and place of use and not on a temporary location.
- b. Note that only certain states offer this exemption and they will have their own unique requirements for claiming it. For example, Illinois requires that a customer claiming this exemption be registered specifically for it. Other states may simply require a signed statement claiming the exemption for the specified property.

4. Packing/Packaging Materials Exemption

- a. Many states offer this exemption for packing materials, such as shipping boxes, packing peanuts, and similar items. The logic here is that the items are treated as exempt sales for resale if they are purchased to package TPP that is then sold at retail. For example, a mail order retailer of sporting goods buys 10,000 shipping boxes and 20,000 feet of bubble wrap. They use these items to ship out sporting goods purchased by customers. The boxes and bubble wrap are exempt because they are considered to be sold to the customer along with the sporting goods.

5. Research and Development Exemption

- a. Similar to the aforementioned manufacturing exemption, the research and development exemption is offered by many states for purchases of tangible personal property that is directly used to research and develop new items of TPP. Once again, the key here is that the items are only exempt if they are directly used in research and development. See the applicable state statutes for the specific rules as they may vary from state to state.

6. Food and Grocery Items

- a. When you go to the grocery store you may have noticed the sales tax on your receipt is at a different rate when you buy other items, or there is no tax at all. This is because many states exempt the sale of grocery items or tax them at a reduced rate. The key to remember here is that most states only offer this exemption on food for human consumption that is consumed off the premises of where it was purchased. In common terms, if you buy food that you take home and prepare yourself, it most likely would qualify for exemption. If you go to a restaurant or order take out/delivery it would probably not qualify for the exemption!

7. Other exemptions

- a. In addition to the aforementioned examples, there are many other miscellaneous exemptions that you may encounter in your sales tax endeavors. They may vary widely from state to state and from the common to the curious. For example, many states exempt TPP used for pollution control and medical devices prescribed by a physician. On the curious side, the sale of llamas and alpacas used for various agricultural purposes are exempt from sales tax in Kentucky.
- b. Finally, each state has their own specific exemptions regarding otherwise taxable TPP. For example, the treatment of computer software delivered electronically varies from state to state, as some states may not view it as TPP and thus, not tax it. While these situations are beyond the general scope of this document, you will be able to reference

www.SalesTaxReference.com's monthly Tax Research Analysis documents (TRA's) on the Audit Defense Toolbox page for detailed discussions on such topics.

Now that this section has provided a general overview of the taxation of TPP, it will move on to services. While most states tax all TPP unless there is a valid exemption, the reverse is usually true for services. In general, services are exempt unless expressly stated as taxable by law. Most states will tax a few services, and some states tax numerous services. (Note that some states charge a gross receipts type tax that differs from a sales tax in that it taxes all gross receipts of a business, including all services. This document only covers sales tax type transactions). While this document will not go into detail about the various types of services that may be taxed in each state, it will discuss three concepts that are very important in relation to the taxation of services in an audit. These concepts are:

1. Mixed Transactions

- A mixed transaction is a combined sale of taxable TPP and nontaxable services where the sales price of each component can be separately identified and quantified through means other than the sales invoice.
 - An example is an invoice that reads: "Training and materials \$1,000.00." The cost of the items on the invoice is not separately stated, however the taxpayer provides a copy of a contract that shows the training was for \$700.00 and the materials were \$300.00, thus there is proof that only \$300.00 of the \$1,000.00 should be taxed.

2. Bundled Transactions

- A bundled transaction is a combined sale of TPP and services where the sales price of each component can not be separately identified and quantified. Using the example above, the invoice still reads "Training and materials \$1,000.00." However there is no contract or other documentation that breaks down this total between the taxable TPP and

nontaxable services. Because of this fact, many auditors will treat the whole \$1,000.00 as taxable.

3. The “True Object” test

- The “True Object” or “Essence of the Transaction” test is a legal concept that is often applied to bundled transactions. When deciding if a bundled transaction is taxable as a sale of TPP or exempt as a sale of service, the taxpayer must ask “what is the true object of the purchaser?” Is the purchaser’s true object of making the purchase the receipt of the TPP or the receipt of the service?
 - For example, in the case of a purchaser that commissions an artist to paint a family portrait, his true object is most likely the receipt of the painting - the TPP, not the service of the artist.
 - In the case of the purchaser that contracts with a CPA to prepare a tax return, her true object is the receipt of the CPA’s professional services, not the paper the tax return is printed on - the TPP.

These concepts are important to understand because they often come up in sales tax audits and are especially difficult to defend. Sales/use tax professionals will always try to prove that a specific sale is a mixed transaction versus a bundled transaction, as they may then be able to reduce the taxable amount to only a portion of the sale. This is accomplished by using other sources of information to support a breakout of the amount billed on an invoice. This may include a copy of a sales contract, internal product/service cost information, or other methods that support the breakout between taxable TPP/nontaxable services.

As mentioned above, a mixed transaction that cannot be broken down and documented will be treated as a bundled transaction and will probably be taxed on the full amount by most state auditors. If this is the case, there is not much a taxpayer can do other than to adjust future billing methods and invoice descriptions so that the problem does not occur

again in future audits. This is also where the “true object” test, as described above, may be a valuable tool to a taxpayer. However the “true object” concept may be difficult to prove to an auditor. This is because the use of such a method is more of a tax theory defense versus the “black and white” documentation defense that most auditors rely on. Because of this, proving that the “true object” of a transaction is the non-taxable service may require going above the auditor. This may include discussing the issue with the audit supervisor, mutually agreeing with the auditor to request a private letter ruling, or fighting the issue in appeals/the courts. In spite of this, if you believe that the “true object” test does apply to your situation don’t hesitate to use it to defend your business!

Now that this section has provided a general overview of the taxation of TPP and services in relation to an audit, let’s talk about how to determine if a product or service is tax exempt. Most sales/use tax professionals accomplish this by using their tax research skills. The ability to locate and analyze tax law is a key tool in an audit defense and this is where an experienced sales/use tax professional can be a huge asset to the audit defense process. If you don’t have access to such a professional, anyone with a fundamental understanding of sales tax law should be able to perform enough research to be dangerous. Remember, the more experience you have reading the law, the better you will become at analyzing it, so read up and practice!

Most tax professionals will use a commercial service via the Internet to perform their tax research. If you don’t have access to these services, almost every state department of revenue website provides their tax code, regulations, and other reference materials online. You can use the links provided under each state at www.SalesTaxReference.com to access these sources. The key difference between the commercial services and the applicable state resources is that the commercial services usually offer superior organization and ease of use.

If you are new to tax research it is very important to understand the basic structure of tax research sources. The following is a general primer: There are various sources of law available to taxpayers, but each source does not carry the same “authority” or strength. Sources with primary authority, or the greatest strength, include statutory, administrative,

and judicial sources. Sources with secondary authority, or limited strength, include tax journals, newsletters, or other unofficial documents (one example is this document!). This section of the toolbox will only discuss sources with primary authority, as taxpayers should never rely on secondary authority sources to defend an audit! The primary sources of law include:

1. Statutory:

- a. Statutory sources are the basis for all sales tax law and include the state code and statutes issued through the state legislative bodies. These sources carry the most weight and all other sources will reference or 'flow into' these documents.

2. Administrative:

- a. Administrative sources include all regulations, rules, rulings, and other documents issued by the various state departments of revenue. The purpose of administrative sources is to interpret and explain how the statutory sources are to be applied. Novice tax researchers will find that these sources provide much more detail in explaining the law when compared to the statutory sources.
 1. Regulations/Rules: The state department of revenue's official interpretation of the related statutory source. This is what the state auditor will probably reference the most when performing your audit.
 2. Revenue Rulings/Letter Rulings: Official pronouncements issued to specific taxpayers that have written the State with a tax question on their specific situation. It is very important to note that letter rulings only carry the force of law for the taxpayer that they are issued to! However, they are useful to other taxpayers because they often provide insight into very specific situations that may be similar to an issue they are currently experiencing.

3. Other sources: Each state may have other administrative sources as well. These may include various administrative notices, publications, and pronouncements.

3. Judicial:

- a. Judicial sources include all the collected rulings issued by the various Federal and state courts. Like with the administrative sources, the purpose of judicial authority is to interpret and apply statutory authority. Judicial sources are extremely valuable for complex issues where the correct interpretation of the statutory and administrative sources is not obvious.

As previously mentioned, performing accurate tax research takes experience and practice. The aforementioned sources can be filled with “legalese” that inexperienced taxpayers may have difficulty interpreting. Unskilled taxpayers should do their best to perform tax research. If you are experiencing an audit issue that is especially large or complex, it may be best to consult a sales/use tax professional with the applicable experience.

Did the Customer Already Pay the Corresponding Use Tax?

If the customer is not exempt and the product or service is not exempt, the next tool that sales/use tax professionals may use to reduce an audit liability is to check if the purchaser already paid the use tax on the transaction. If they did and the taxpayer can prove this to the auditor, the item will be removed from the auditor’s taxable schedule. Keep in mind that each state may have its own rules on how this needs to be documented. Most states accept a signed statement from the customer that the use tax was paid on the purchase or that they were already audited for the period, but some states may require more documentation.

The logic behind this concept is that the sales tax and use tax are complementary taxes. In theory, only the sales tax or the use tax should apply to each transaction, never both! While a sales tax is generally defined as a tax on the sale or transfer of a taxable item or

service, the use tax is generally defined as a tax on the storage, use, or consumption of a taxable item or service on which no sales tax was paid. Each state has both a sales tax and a use tax so that taxpayers cannot avoid paying tax on a taxable transaction by making a purchase from an out of state vendor and bringing it into their home state. For example, Taxpayer A can buy a new coat from the department store in his home city. The store will charge him the applicable sales tax and he will have to pay it in order to buy the item. In contrast, Taxpayer B can buy the same coat from an Internet store that does not have nexus with his state. Because the Internet business does not have nexus, they will not charge Taxpayer B any sales tax. This is where the use tax comes into play. Because Taxpayer B is using the coat in his state, he is supposed to self-assess the use tax (usually the same rate as the sales tax) and remit it to the state. Obviously, most individuals never pay the use tax on this type of purchase, as it is almost impossible for states to audit individual's use tax purchases. However, businesses are not so lucky, since if they are ever audited, the auditor will most definitely review their expense and fixed asset purchases and assess tax on this type of transaction!

For audit purposes, if the taxpayer can prove that the purchaser already paid the use tax to the state, they are not liable for the corresponding sales tax. In order to accomplish this, sales/use tax professionals will attempt to contact the customer by sending out a "self-assessment letter" along with a phone call and/or e-mail to the customer explaining the situation. Numerous follow up phone calls and/or e-mails may be required as well. The basic premise of the letter is to:

1. Inform the customer of the situation:
 - a. "We are currently undergoing a sales tax audit by State A and purchases made by your company were identified as taxable exceptions"
2. Identify the specific purchases:
 - a. List the invoice number(s), invoice date(s), and invoice amount(s) of the purchases in question.
3. Request the purchaser's assistance:

- a. We respectfully request your help in confirming any of the following with regards to these invoices:
 - i. These invoices are exempt and you can provide a resale or exemption certificate.
 - ii. You have self-assessed and remitted the use tax on these invoices directly to the state.
 - iii. You have been audited by State A for the time period in which these purchases were made.

[Here](#) is an example letter that taxpayers can use as a template for their own version.

Remember that using the self assessment letter is basically equivalent to asking your customer to 'bail you out'. Most sales/use tax professionals only have limited success in using self assessment letters, as customers are not required to even respond to such letters. However they are a valuable tool in the audit defense arsenal and should be utilized when other methods fail.

Now that we have discussed the common tools for defending against a sales tax audit, this section will now provide an overview of the tools used to defend against a use tax audit. Keep in mind that many of the tools used on the sales tax side can also be used on the use tax side!

A General Overview of Use Tax Audit Defense Tools

As discussed in Section One, a use tax audit is composed of an examination of a business' purchases. This includes expensed purchases, such as office supplies, and capitalized purchases, such as office furniture and computers. Similar to sales tax audits, sales/use tax professionals will address each individual taxable exception and ask the following questions:

1. Is the product/service purchased exempt?
2. Did we self-assess use tax on the purchase?
3. Did the seller already pay the tax on audit?

Once again, by asking these questions, a sales/use tax professional is attempting to exhaust all possible means to prove that each item on the auditor's 'taxable' schedule(s) was correctly purchased tax free.

Is the Purchase Exempt?

Most of the common tools used to defend a use tax audit are the same as those used on the sales tax side. However, there are a few additional use tax items this document will address:

1. Purchases from construction contractors:

- a. In most states, construction contractors are considered the consumers of any TPP used in performing their work for customers. What this means is that if you make a purchase of TPP from said contractor as part of a construction contract, you do not owe any sales tax because the contractor had to pay it when he first bought the property and "consumed" it in his work.
 - i. Always remember to check with your specific state to make sure they offer this exemption and/or have any rules that differ from the norm.

2. Purchases with Multiple Points of Use:

- a. This tool applies to a purchase that the taxpayer will be using in multiple locations/states. For example, Lets say you are working on a Texas audit defense. An invoice on the audit of capitalized purchases shows that you bought 500 licenses of a taxable software program. The invoice has a 'ship to' Texas address. In most cases, the total invoice amount would be taxable. But if you can show through other documentation that 400 of the 500 invoices were actually used outside of Texas, then you may be able to exclude 4/5ths of the invoices from the audit.

- i. This tool is useful for other types of purchases as well. Some examples include catalogs mailed to customers and other free or promotional materials given away to customers.

Did We Self-Assess Use Tax on the Purchase?

This technique is fairly straight forward if you have use tax procedures in place, since you would be able to track any applicable self-assessments on purchases. In contrast, if you do not self-assess tax on any purchases this option is not available to you. If this is the case, you may want to start working with Account Payable to develop procedures to self-assess the tax on any taxable purchases and remit said tax on your returns.

Did the Seller Already Pay the Tax on Audit?

If the TPP or service under audit is taxable and all of the above techniques fail, you may want to contact the seller to see if they have been audited already by the state. Similar to the related topic discussed in the sales tax portion of this section, you would ask the seller to fill out a XYZ letter which states that the retailer was already audited for this time period. If this is successful, the auditor would remove the item from your taxable schedule because the same transaction cannot be subject to the use tax and the sales tax.

Section one of the Toolbox has provided a general overview of the various stages of an audit and section two has detailed the most common methods used by tax professionals to limit audit liability. The final section of the Toolbox will present a general discussion of some miscellaneous audit topics that may arise on your audit. These topics may include:

1. The Statute of Limitations Waiver: When to Sign, When to Negotiate
2. Problem Auditors: "You Can't Stop Them, You Can Only Hope to Contain Them"
3. Charge It!: The Use Tax Impact of Company Procurement Card Systems
4. Promo/Marketing Items and Use Tax
5. Drop Shipment Headaches

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